

Stranded Gas Hearings

(0406161600 Minutes)

Just and Reasonable Pipeline Tariffs

Nan Thompson, Commissioner, Regulatory Commission of Alaska (RCA), Dept. of Commerce, Community, and Economic Development, June 16, 2004.

NAN THOMPSON, Commissioner, Regulatory Commission of Alaska (RCA), Department of Community & Economic Development (DCED), said she would be offering a historical perspective on what rate regulation on pipelines has meant under Alaska law, and her experience regarding regulating pipelines. She began by talking about the AS 42.06, which sets a standard for rates as just and reasonable and based on cost. The aforementioned statute states a clear policy that parallels the policy for rate setting on pipelines, both for utilities and pipelines across the country. That statute created a regulatory agency with authority to set cost-based rates. She related that the reason agencies like the RCA exist at all is because utilities and, in some cases, pipelines are monopolies. Therefore, regulation is necessary to ensure that prices are fair. Agencies such as the RCA are thought of as a replacement, economically, for the market, which doesn't exist in monopoly services like utilities. "It's the responsibility of the regulatory agency in this context to look at the costs of the pipeline, or the utility, the cost of building the pipeline, and provide them a reasonable opportunity to recover their investment," she explained. The agency must review the ongoing costs and the original cost of construction in order to determine how the entity can recover a return on its investment, all of which is factored into the rates.

MS. THOMPSON said, "There isn't a perfect answer to rates." However, under the law there is a zone of reasonableness for which there is considerable case law across the country. The case law specifies that compensatory rates are those that aren't less than compensatory. In other words, the [pipeline owner/investors] are allowed a reasonable opportunity to recover costs "and they're not excessive." Therefore, RCA's role is to review the detail of the costs and strike the balance. Ms. Thompson added that AS 42.05 addresses affiliate costs, which is applied to pipelines and utilities in Alaska. When some of the costs included in the operations or construction of a pipeline are incurred by an affiliate, this statute ensures that the pipeline rates don't include any costs higher than would've been paid if those same services were performed by a third party.

MS. THOMPSON informed the committees that the RCA uses a formula to determine rates for a utility or pipeline. Basically, the return is determined by reviewing the capital structure, the cost of debt, and a risk adjustment if that's appropriate. That return is multiplied by the rate base, which is what it costs to build the asset minus depreciation. Then, the aforementioned is added to the operating expenses, depreciation, and taxes. Therefore, a rate case before an agency like the RCA is lawyers and experts presenting evidence with regard to what the numbers that get plugged into that equation should be. Therefore, the RCA uses the formula consistently to ensure that the rates are just and reasonable. She said, "It's really the determination of what those different inputs are that's the challenging part of a rate case." She provided an example. On depreciation, utility [owners and pipeline owners] are entitled to recover the costs they put into building the asset. Therefore, questions arise regarding the time period [of recovery] and the schedule [of recovery]. The RCA reviews what is going to be fair to the shippers, now and in the future. If all of the costs are recovered early in the life of the pipeline, then arguably the earlier shippers bear more of the burden than the later shippers. However, if much of the costs are recovered early, then what incentive will the pipeline owners have, in later years, to continue to operate the line, she asked. She highlighted that it's not uncommon for the expected life of a pipeline to change over time.

MS. THOMPSON turned to the litigation history of TAPS, which she suggested would probably be a good case to understand while contemplating the gas [pipeline]. She informed the committees that when the pipeline was constructed, there was a lot of dispute regarding what rates would be charged for shipment on it. The legislature became involved in hearings, and there was much fact-finding before the RCA. Litigation, in several different forums, went on for about 10 years when the parties settled. The aforementioned resulted in what's known as TSM, or the TAPS settlement methodology. Due to the statute that specifies the regulatory commission has a responsibility for just and reasonable rates, it was

presented to the agency for approval. The APUC [Alaska Public Utilities Commission], as the RCA was named at the time, accepted the TSM. "They didn't approve it - they accepted it," she emphasized.

MS. THOMPSON added:

They said ..., "All the parties who are here before us today are telling us this is a good idea, [and] we're not going to take the time" for whatever reason "to do the type of analysis we normally do to ensure that the rates are cost-based; we're going to accept this settlement [because] the parties agree." It was an efficiency decision. But they said, "If there's ever a protest, we're going to have to revisit this ... because we don't know ... a lot about what we're approving, we don't know exactly what some of the numbers are in this settlement, but it's okay because the parties agree."

MS. THOMPSON related that there was a methodology under which filings were made annually, with some cost information, by the TAPS carriers. The rates were adjusted based on those. In 1997 one of the shippers protested and charged that the rates were too high, and therefore the process began for reexamining [the methodology]. Eventually, there was a five or six week long hearing to gather evidence in order to make a decision. She noted that there were a lot of pretrial motions. Ms. Thompson said:

But the difficulty in that case, which explains why the order concluding it was so long and the proceeding was so complex, was that when the original settlement was approved, they never had clear pegs for some of the numbers. The agency had not made a finding, ... for example, [that] the amount of depreciation [in] the order was just and reasonable. Nobody knew. They were ... numbers that the parties had agreed on, but the agency hadn't done what it was supposed to do ... [per] the statute in making a just and reasonable finding.

MS. THOMPSON explained that in order for the RCA to determine what the rate should have been in 1997 when the protest was filed, it had to determine how much of the asset the pipeline had already recovered through rates. Therefore, much of the testimony in that proceeding was reviewing a lot of detailed, historic records to determine a fair place to start from. The aforementioned necessitated deterring how the rates calculated under this TSM compared to cost-based rates, which was the directive in the statute. Upon reviewing the evidence to compare those two types of costs, it was determined that the [pipeline owners] had a significant opportunity for recovering more than the costs they had incurred to date. Therefore, the rates were set going forward.

MS. THOMPSON stated that the biggest adjustment was in depreciation. The [carriers] argued that what had been characterized as depreciation, the TSM filings for 20 years, wasn't really depreciation after all. [The carriers argued] that they hadn't really recovered as much as they had been identifying as depreciation over the years, and therefore the RCA should allow them to recover more. However, the agency didn't find that argument plausible and decided to use the amount that the [carriers] had already charged shippers for depreciation while using straight-line depreciation going forward. She explained that when the RCA compared cost-based rates to TSM rates, the TSM rates were 57 percent higher over that period of time, which was a rather significant difference between what the settlement methodology produced and what the RCA thought fair, cost-based rates should have been. Therefore, the RCA set the rates going forward as it would in any other rate case. "I think the importance of this case and the lesson for you when you're considering how the gas [pipeline] tariff should be set, and I think probably even the carriers would agree that going through that process is something they would want to avoid the second time, ... [is that] it was enormously expensive," she highlighted. In fact, at one point in the process the carriers were required to file litigation-cost reports because those are arguably recoverable in rates. She recalled that the last litigation-cost report was about \$14 million, which is a huge sum of money that might have been more productively spent on something else. "The importance of process ... is something to think about when you're thinking about how you might avoid this circumstance again," she said. She further said:

What that case told us is that as a result of the commission deciding, "Well, we'll just accept the settlement because everybody agrees," and they were under enormous pressure at the time from folks who had been litigating for 10 years and saying, "Look, we agree, it's all over, don't look at this," it created a problem that has taken ... it's successors many years to live (indisc.) ... [tape changed sides mid-sentence.]

MS. THOMPSON continued [tape begins mid-sentence]: "... the settlement methodology produced. The cost based rates were significantly lower." She remarked that transparency in the process has been a

problem throughout. The RCA makes sure that services provided on a monopoly basis are at a fair price and understandable to the public or anyone who has to pay those rates. However, when things are filed at settlement, often the settlement documents are not always public. Furthermore, the pipeline tariffing process is less transparent than the utility tariffing process. Ms. Thompson related her personal belief that a public process is often fairer. "Sometimes you need to have information in order to be able to file an appropriate protest or in order to be able to certainly put on a good case before us," she explained. Therefore, the rules need to be fair and allow potential shippers the opportunity to become involved in the rate-setting process while providing information about what they think is fair or not. She encouraged the committees to ask questions, explaining that reasonable rates are important because when encouraging development one needs to think about who the shippers are in the line right now as well as the shippers who may be or want to be in the future. She also encouraged the committees to make sure that the rates are reasonable so that in the long term, development can be encouraged.

MS. THOMPSON opined that if she had been on the commission at the time the settlement was presented, she would've argued that the commission should've reviewed the settlement under the just and reasonable standard rather than accepting the settlement because everyone agreed. "It's always going to be guesswork to some extent when you're setting rates," she remarked. Under a normal utility context rates are adjusted every four or five years or if there's a major change. "You don't have to guess what the rates are going to be for 20 years, you have to guess over a reasonable time horizon, which varies with the utility, depending on what their operations are like," she said. She noted that the decision in this case is on the RCA's web site.

MS. THOMPSON noted that the other argument/discussion one may have in the context of gas line rates, is regarding comparison to FERC and why other RCA's processes are different than FERC. She explained, "There's one important significant difference between what FERC does and what we do as a state regulatory agency and that is most of FERC's pipeline regulatory structure in the Lower 48 is very different but that's because there's competition. There's often down there more than one-way to get the gas to market." However, it's unlikely that there's going to be more than one gas pipeline from the North Slope, at least in the foreseeable future. Therefore, some of the market-based rate-setting mechanisms that FERC uses probably aren't appropriate in this context because there are no competitors to discipline prices. She concluded by relating that continued enforcement of the just and reasonable rate will best ensure long-term stability in the gas market.

CHAIR OGAN said that previous speakers have testified that ratemaking is very transparent so there should be no overriding tariff issues. The FERC would regulate the pipeline while the RCA would have a seat at the table and play more of an advisory role. He asked Ms. Thompson what rate-setting mechanism she would suggest if FERC's process is not appropriate to Alaska's single gas line.

MS. THOMPSON said RCA's only jurisdiction will be over intrastate shipments – gas that comes off the line within the state. The RCA collaborated with FERC on the TAPS case and others, and the two agencies have signed a memorandum of understanding to work cooperatively on pipeline issues. She noted, as an example, the Quality Bank case has been before both agencies for many years; the RCA and FERC held concurrent hearings on the case last year. FERC and the RCA have a history of cooperation that has been somewhat institutionalized. She said the RCA has no interest in regulating interstate rates.

CHAIR OGAN asked Ms. Thompson to elaborate on her comment that FERC's regulatory process is designed for the Lower 48 where competition exists and on how it will consider the Alaska rates.

MS. THOMPSON explained:

What I was trying to articulate was that the methodologies they use for setting gas pipeline rates in the Lower 48, not necessarily their jurisdiction over this line – I don't know how they're going to regulate this line, whether they will apply a different regulatory review standard than they do in the Lower 48 gas pipeline. But in the Lower 48, gas pipeline rates are set under a very different mechanism and there's a minimal standard of review, at least economically, because there are

market forces that operate there to keep those lines reasonable - there's competition. ... The owners of the pipeline have incentives that don't exist when there's only one route to keep the rates low. I don't know what they will use to set rates for this line. That may or may not be true. I wasn't trying to draw a comparison between their regulation of this gas pipeline but more gas pipeline regulation in general.